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*of the*  
**U.S.-CHINA ECONOMIC AND  
SECURITY REVIEW COMMISSION**

ONE HUNDRED EIGHTH CONGRESS  
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## U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

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The Commission was created in October 2000 by the Floyd D. Spence National Defense Authorization Act for 2001 sec. 1238, Public Law 106-398, 114 STAT. 1654A-334 (2000) (codified at 22 U.S.C. sec. 7002 (2001)), as amended, and the "Consolidated Appropriations Resolution of 2003," Public Law 108-7, dated February 20, 2003. Public Law 108-7 changed the Commission's title to U.S.-China Economic and Security Review Commission.

The Commission's full charter is available via the World Wide Web: <http://www.uscc.gov> and begins in Appendix I, page 233.

### IN MEMORIAM

This Report is dedicated to the memory of the Honorable Robert A. Bean, who served the Commission with distinction as a key advisor and director of Congressional and public affairs. He was a trusted and highly valued close advisor and good friend to the Chairman, Vice Chairman, Commission Members and staff. Bob's passing on May 14, 2004, was tragic and untimely. He will be deeply missed by all who knew him.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

JUNE 10, 2004

The Honorable TED STEVENS,  
*President Pro Tempore of the U.S. Senate, Washington, D.C. 20510*  
The Honorable J. DENNIS HASTERT,  
*Speaker of the House of Representatives, Washington, D.C. 20515*

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit our second annual Report to the Congress, pursuant to Public Law 106-398 (October 30, 2000), as amended by Division P of P.L. 108-7 (February 20, 2003). The Commission has again reached a broad and bipartisan consensus, this year approving the Report by a unanimous vote of all eleven Commissioners (11-0), on the most important aspect of our mandate, "to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China."

The Report includes a detailed treatment of our investigations into the areas identified by the Congress for our review and recommendations in the amendments of 2003. These areas are: China's proliferation practices, China's economic reforms and U.S. economic transfers to China, China's energy needs, Chinese firms' access to the U.S. capital markets, U.S. investments into China, China's economic and security impacts in Asia, U.S.-China bilateral programs and agreements, China's record of compliance with its World Trade Organization (WTO) commitments, and the Chinese government's media control efforts.

The Report is organized into an Executive Summary, which highlights our general assessments, conclusions and key recommendations in the areas of investigation, and is followed by detailed treatment of each area in nine separate chapters. We believe the level of bipartisan consensus the Commission has achieved is significant given the number of controversial issues the Congress directed us to investigate, and the continuing and growing concern over the direction of the U.S.-China relationship politically, economically and strategically over the next decade or more. We have operated under a key assumption of our mandate, that the United States' economic health and well-being are a fundamental national security matter, including the maintenance of a strong manufacturing base, a vigorous research and development capability, the ability to maintain our global competitiveness and a healthy employment level and growth rate.

This Commission arose from the debate that led the Congress to approve Permanent Normal Trade Relations (PNTR) for China and U.S. support for China's admission to the WTO, despite the fact that China clearly had not achieved the level of free market development normally required for WTO membership. The administration argued strenuously during that debate that including China in the world trading system would lead to political reform and a more open Chinese society to accompany the development of market economics. These expectations have, so far, been disappointed by China's lack of progress on any important measurements of political reform, human rights, openness, and the building of democratic institutions. That is the central dilemma of our bilateral relationship: that China remains an undemocratic, authoritarian state, while it is opening its market and seeking the respect and support of its trading and investment partners. This gap between our political and value systems is magnified by the fact that we compete for economic and political influence in Asia. As a result, the U.S.-China relationship is variously categorized as strategic engagement and competition. In some areas there is promising cooperation, in others sharp antagonism.

Certain fundamental issues have guided the Commission's work, and they span the broad range of topics mandated for review by the Congress. Those central issues include the questions of China's progress in four broad areas: (1) market reforms and trade commitments, (2) cooperation with the United States on national security matters, (3) policies toward openness, human rights, democracy-building, and the rule of law, and (4) the quality of the overall bilateral relationship. In most of these areas, the Commission believes China's progress has been far less than satisfactory, and that it is in the U.S. interest to continue to press China to do more. On the range of questions dealing with openness, human rights, democracy-building, and the rule of law, the Commission believes China simply fails to meet a minimal standard of progress.

This Report includes a number of recommendations for Congressional action, ranging from fair dealing in a range of economic arenas, to policies on media openness, to diplomatic strategies such as in the case of North Korea's nuclear weapons program. Some of these recommendations involve renewed efforts to cooperate with the Chinese in a number of areas where we believe the United States must use its influence to encourage China to live up to its commitments and to act as a responsible world power. In all cases, our success will depend to a large extent on the level of cooperation between the executive branch and the Congress on fashioning policies for dealing with China. Success will also depend on other countries actively engaging in a cooperative process with the United States.

The Commission believes that U.S. policies must be firmly grounded on the calculus of what will strengthen and advance our nation's economic health and national security—in a nutshell, our national interests. Second, although it is unrealistic to expect the United States to fundamentally transform the beliefs, structures, and governing dynamics of China's Communist dictatorship, we should continue to advocate strongly democratic values and principles, remembering that in the past strong American actions and influence have successfully brought about such values and practices in Japan, South Korea, the Philippines and Taiwan. On both scores, we can and should do better.

The Commission used a number of approaches to conduct its work on behalf of the Congress, including holding eleven public hearings on a broad range of topics, including field hearings in Columbia, South Carolina, and San Diego, California; new research in a variety of relevant areas; classified briefings from the intelligence community; and fact-finding visits to Asia and also the WTO in Geneva. We published complete hearings records, together with preliminary findings and recommendations in separate volumes for each of our hearings. The original research funded by the Commission is also posted on our Web site ([www.uscc.gov](http://www.uscc.gov)).

We believe that this Report will provide a baseline for assessing progress and challenges in the U.S.-China relationship. We believe that the relationship is still in a fluid state and that the United States has an historic opportunity to help move China in directions that will be beneficial for its own development and for peaceful bilateral relations with the United States, the Asian region and the world community. In many ways, we believe the direction of the world trading system, and so-called globalization, will be significantly influenced by the progress that is made in our bilateral relationship. We encourage the Congress to become a genuine partner with the administration in formulating and evaluating this complicated and many-faceted relationship because we are persuaded that the quality and success of American policies toward China are far more likely to succeed if they originate from a bipartisan consensus with the administration. We hope this Report and the continued work of the Commission will contribute to facilitating and informing that process.

Yours truly,



Roger W. Robinson, Jr.  
*Chairman*



C. Richard D'Amato  
*Vice Chairman*

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## EXECUTIVE SUMMARY

This Report sets forth the Commission's analysis of the U.S.-China relationship in the designated areas of investigation in our Congressional mandate: China's proliferation practices, China's economic reforms and U.S. economic transfers to China, China's energy needs, Chinese firms' access to the U.S. capital markets, U.S. investments into China, China's economic and security impacts in Asia, U.S.-China bilateral programs and agreements, China's record of compliance with its World Trade Organization (WTO) commitments, and the Chinese government's media control efforts. Our analysis, along with recommendations to the Congress for addressing identified concerns, is chronicled in the Report's nine chapters, and summarized herein.

### OVERALL ASSESSMENT OF ECONOMIC AND SECURITY CHALLENGES

Along with specified areas of investigation, Congress gave the Commission the overarching mission of evaluating on an annual basis "the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China (PRC)." As reflected in our Congressional mandate, the Commission takes a broad view of "national security" in making this assessment. We have attempted to evaluate how the U.S. relationship with China affects the economic health of our nation, our industrial base, the military and weapons proliferation dangers we face, and our political standing and influence in Asia. Taken together, these elements paint a full picture of how the relationship impacts our broader national security interests.

*Based on our analyses to date, as documented in detail in our Report, the Commission believes that a number of the current trends in U.S.-China relations have **negative implications** for our long-term economic and national security interests, and therefore that U.S. policies in these areas are in need of urgent attention and course corrections.*

Nonetheless, the Commission believes that the time is ripe for putting the U.S.-China relationship on a more solid, sustainable footing from the perspective of long-term U.S. interests. The U.S.-China relationship is still in the relatively early stages of its development and is marked by a fluid rather than static environment. The United States has played—and continues to play—an enormous role in the economic and technological development of China. As the Commission has documented through our hearings and reports, U.S. trade, investment, and technology flows have been a critical factor in China's rise as an economic power. We need to use our substantial leverage to develop an architecture that will help avoid conflict, attempt to build cooperative practices and institutions, and advance both countries' long-term interests. The United

States has the leverage now and perhaps for the next decade, but this may not always be the case. We also must recognize the impact of these trends directly on the domestic U.S. economy, and develop and adopt policies that ensure that our actions do not undermine our economic interests.

When the Congress approved Permanent Normal Trade Relations (PNTR) for China, the guiding premise was that it would expand market access for U.S. goods and services and, more fundamentally, would lead to economic reform in China and, eventually, political reform. In this context, it was characterized as in our “national security interest” to support China’s accession to the WTO. Having taken this significant step, the United States cannot lose sight of these important goals, and must configure its policies toward China to help make them materialize—from expanded trade opportunities for U.S. exporters and a mutually beneficial trade relationship that sets global standards for fair trade, to an open, more democratic society in China that can be an important partner in addressing regional and global security challenges, including weapons proliferation, terrorism, and peaceful resolution of the cross-Strait situation.

The Commission examined in depth the extent of ongoing cooperation between China and the United States on traditional national security matters, most particularly China’s assistance in resolving the North Korea nuclear weapons crisis. The Commission believes that China’s performance in this area to date has been unsatisfactory, and we are concerned that U.S. pressure on trade disputes and other unrelated aspects of the relationship may have been toned down by the administration as a concession for China’s hoped-for cooperation on this and other vital security matters. The Commission believes that any real progress with China on both the trade and security fronts will require the use of substantial and continuing leverage on the part of the United States.

If we falter in the use of our economic and political influence now to effect positive change in China, we will have squandered an historic opportunity. We believe China demonstrated a willingness to move in a positive direction, and to take substantial risks to do so, when it entered the WTO. But China will likely not initiate the decisive measures toward more meaningful economic and political reform without substantial, sustained, and increased pressure from the United States. And while the United States must pursue its own interests, it is vital for other nations to join our efforts if we are to succeed. Our recommendations to Congress in this Report provide our assessment of particular tools the United States can use to exercise its leverage.

### **KEY FINDINGS AND RECOMMENDATIONS**

The Report presents its key findings, analysis, and recommendations to Congress in nine chapters, organized in three sections capturing the major themes of our Congressional mandate. While our analysis has been divided in this manner, all of these areas interrelate in assessing the broader question of how the U.S.-China economic relationship affects U.S. economic and national security interests. We recognize that the United States’ vast economic trans-



fers to China are inseparable from the larger geopolitical and military developments at issue.

We include within this Executive Summary our priority recommendations to Congress. A full list of the Report's recommendations, by chapter, follows in a separate section.

### **U.S.-China Trade and Economic Transfers**

Bilateral trade and investment flows between the United States and China are taking place on a massive and rapidly increasing scale. Assessing how these flows are affecting the U.S. economy—and with that U.S. economic security—is an essential area of the Commission's work.

### ***Litmus Test for Global Trade Relations***

The development of the U.S.-China economic relationship has broader implications for the path of globalization writ large. As generally understood, globalization refers to the process of creating a unified global economy through the breaking down of barriers between national economies. It encompasses the increased integration of national goods, financial, and labor markets. In goods markets, globalization takes the form of increased goods and services trade between countries and the internationalization of production through global supply chains. In labor markets, it manifests itself through increased labor migration and movement of production to labor markets that are the most cost-effective in terms of wages and working conditions, whether or not they are the result of artificial conditions. In financial markets, it shows up in the international diversification of investor portfolios and increases in cross-border financial flows.

*The Commission believes that the U.S.-China economic relationship is of such large dimensions that the future trends of globalization will be influenced to a substantial degree by how the United States manages its economic relations with China. It is reasonable to believe that U.S.-China economic relations will help shape the rules of the road for broader global trade relations. If current failings are remedied and the relationship is developed so as to provide broad-based benefits for both sides, globalization will likely be affected in a positive manner on a worldwide scale. If not, the opposite will likely be true.*

Further, the Commission recognizes that many of the challenges facing the U.S. economy from globalization require changes in U.S. policy that go well beyond specific responses to China's practices. Improving U.S. economic competitiveness and the welfare of U.S. workers will require actions including enhanced national commitments to education, infrastructure modernization, changes in U.S. tax policy to encourage U.S.-based production and research and development (R&D), and to more comprehensive retraining programs for U.S. workers negatively impacted by trade. However, given our mandate, we have focused our recommendations to Congress on items tailored to meet the more specific economic challenges of China.

***The Imbalanced U.S.-China Trade Relationship and the Consequences for the U.S. Economy***

The dominant feature of U.S.-China economic relations is the U.S. goods trade deficit, which rose by more than twenty percent in 2003 to a record \$124 billion. This deficit now constitutes over twenty-three percent of the total U.S. goods trade deficit, and China is by far the largest country component of the deficit. Moreover, U.S. trade with China—with \$28 billion in exports to China as compared with \$152 billion in imports in 2003—is by far the United States' most lopsided trade relationship as measured by the ratio of imports to exports. China is heavily dependent on the U.S. market, with exports to the United States constituting 35 percent of total Chinese exports in 2003.

A key factor contributing to the U.S. deficit with China is the undervaluation of the Chinese yuan against the U.S. dollar. This gives Chinese manufacturers a competitive advantage over U.S. manufacturers. Economic fundamentals suggest that the Chinese yuan is undervalued, with a growing consensus of economists estimating the level of undervaluation to be anywhere from fifteen to forty percent. The Chinese government persistently intervenes in the foreign exchange market to keep its exchange rate pegged at 8.28 yuan per dollar, and through these actions appears to be manipulating its currency valuation. A second factor contributing to imbalances in U.S.-China trade is China's mercantilist industrial and foreign direct investment policies. These policies involve a wide range of measures including technology transfer requirements, government subsidies, discriminatory tax relief, and limitations on market access for foreign companies. Finally, China's labor markets do not provide adequate recognition of workers' rights, thereby resulting in artificially low wages that disadvantage our economic interests.

*The U.S. trade deficit with China is of major concern because (i) it has contributed to the erosion of manufacturing jobs and jobless recovery in the United States, (ii) manufacturing is critical for the nation's economic and national security, and (iii) the deficit has adversely impacted other sectors of the U.S. economy as well. Therefore, our trade and investment relationship with China—with current trends continuing and the deficit expanding—is not just a trade issue for the United States, but a matter of our long-term economic health and national security.*

**Recommendation:** In the absence of concrete progress by the administration in moving China toward a substantial upward revaluation of the yuan against the dollar and to repegging the yuan to a trade-weighted basket of currencies, Congress should pursue legislative measures that will direct the administration to take action—through the WTO or otherwise—to combat China's exchange rate practices. The administration should concurrently encourage our trading partners with similar interests to join in this effort.

**Recommendation:** Congress should direct the United States Trade Representative (USTR) and the Department of Commerce to undertake immediately a comprehensive investigation of China's system of government subsidies for manufacturing, including

tax incentives, preferential access to credit and capital from state-owned financial institutions, subsidized utilities, and investment conditions requiring technology transfers. The investigation should also examine discriminatory consumption credits that shift demand toward Chinese goods, Chinese state-owned banks' practice of noncommercial-based policy lending to state-owned and other enterprises, and China's dual pricing system for coal and other energy sources. USTR and Commerce should provide the results of this investigation in a report to Congress that assesses whether any of these practices may be actionable subsidies under the WTO and lays out specific steps the U.S. government can take to address these practices.

### ***China's Mixed Record in the WTO***

China joined the WTO in December 2001. Its accession agreement is extremely complex, reflecting the need for special arrangements to address the fact that China does not have a market-based economy. To protect against trade distortions and unfair trade practices resulting from China's non-market status, the agreement includes a special WTO review mechanism—the Transitional Review Mechanism (TRM)—to monitor China's compliance and special safeguard provisions giving WTO members the right to protect themselves against sudden surges of Chinese imports.

*Though China has made progress in reducing tariffs and otherwise formally meeting a large number of its WTO accession commitments, significant compliance shortfalls persist in a number of key areas for U.S. trade. Among areas of concern are China's manipulation of its currency, continued provision of direct and indirect subsidies to Chinese producers, use of unjustified technical and safety standards to exclude foreign products, poor enforcement of intellectual property rights (IPR), and discriminatory tax treatment for domestic semiconductor production. Moreover, China has deliberately frustrated the effectiveness and debased the value of the WTO's TRM, which was intended to be a robust mechanism for assessing China's WTO compliance and for placing multilateral pressure on China to address compliance shortfalls.*

***Recommendation:*** Congress should press the administration to make more use of the WTO dispute settlement mechanism and/or U.S. trade laws to redress unfair Chinese trade practices. In particular, the administration should act promptly to address China's exchange rate manipulation, denial of trading and distribution rights, lack of IPR protection, objectionable labor standards, and subsidies to export industries. On IPR, the United States must take action to force China to enact credible criminal penalties for IPR violations and to greatly enhance enforcement. Another key priority for U.S. trade officials must be ensuring China's compliance with its WTO commitments to refrain from forced technology transfers used as a condition of doing business. In pursuing these cases, Congress should encourage USTR to consult with trading partners who have mutual interests at the outset of each new trade dispute with China.

***Recommendation:*** Congress should press the administration to make better use of the China-specific section 421 and textile

safeguards negotiated as part of China's WTO accession agreement to give relief to U.S. industries especially hard hit by surges in imports from China.

**Recommendation:** Congress should encourage USTR and other appropriate U.S. government officials to take action to ensure that the WTO's Transitional Review Mechanism process is a meaningful multilateral review that measures China's compliance with its WTO commitments. If China continues to frustrate the TRM process, the U.S. government should work with the European Union, Japan, and other major trading partners to produce a separate, unified annual report that measures and reports on China's progress toward compliance and coordinates a plan of action to address shortcomings.

### ***Governance and Security Concerns with China's Outreach to the Global Capital Markets***

The Chinese government has selectively chosen firms—predominately state-owned enterprises (SOEs)—to list on international capital markets, primarily in Hong Kong and New York, and may bring as much as \$23 billion in initial public offerings to global capital markets in 2004, a marked increase over the past few years. Yet, Chinese corporate governance standards lag far behind those in the United States. Accounting and reporting standards are weak, and China lacks a sound, transparent system of credit ratings. As a result, even the most sophisticated investors lack adequate disclosure when it comes to Chinese debt and equity listings in international capital markets.

Moreover, inadequate transparency and disclosure prevents the U.S. government and investors from understanding the possible nexus between Chinese firms listing on U.S. and international capital markets and weapons proliferation and/or China's defense-industrial complex. Many SOEs were previously controlled by the People's Liberation Army (PLA), and there is concern that unofficial links to the PLA remain intact after privatization. At least one firm listed in China's capital markets and available for purchase by qualified U.S. investors—China North Industries Corp.—has been sanctioned for proliferation by the U.S. government, and there are concerns that other Chinese firms listed or trading in China or in the United States may be engaging in similar activities.

*Without adequate information about Chinese firms trading in international capital markets, U.S. investors may be unwittingly pouring money into black box firms lacking basic corporate governance structures, as well as enterprises involved in activities harmful to U.S. security interests.*

**Recommendation:** Congress should reinstate the reporting provision of the 2003 Intelligence Authorization Act [P.L. 107-306, Sec. 827] directing the director of central intelligence (DCI) to prepare an annual report identifying Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in the U.S. capital markets. In addition, Congress should expand this provision to require the DCI to include a broader interagency review of the

security-related concerns of Chinese firms accessing, or seeking to access, the U.S. capital markets that would examine linkages between proliferation and other security-related concerns and Chinese companies, including their parents and subsidiaries, with a presence in the U.S. capital markets.

**Recommendation:** Congress should bar U.S. institutional or private investors from making debt or equity investments, directly or indirectly, in firms identified and sanctioned by the U.S. government for weapons proliferation-related activities, whether they are listed and traded in the United States or in the Chinese or other international capital markets.

We note that these bilateral trade and investment dynamics are occurring at a time of significant economic stresses in China, with growing numbers of economists and financial analysts cautioning about the possible bursting of the bubble in China's economy. These predictions rest on concerns about the economy overheating and on concerns about the weak foundation of the Chinese banking system, which has accumulated nonperforming loans estimated to be \$500 billion after decades of making loan decisions based on policy or political grounds rather than financial considerations.

*These suspect capital allocation practices raise cautionary flags about the sustainability of China's economic boom. It is crucial that U.S. policymakers understand the potential ramifications for the U.S. economy and investors, China's Asian trading partners, and China's domestic stability should China's economic bubble burst.*

### **Regional and Geostrategic Developments**

The Commission examined China's rise as a regional power and its central role in the global security challenges stemming from the proliferation of weapons of mass destruction (WMD) and access to energy supplies. In this examination, we weighed the extent to which China is contributing to or undermining a more stable global security environment.

#### ***China's Regional Diplomatic Offensive***

Through trade and investment, China has become increasingly interconnected with its Asian neighbors. Investors from Hong Kong, Taiwan, Japan, South Korea and Southeast Asia are helping to fuel the export processing industries of China that deliver a wide array of manufactured goods to the United States and Europe through global supply chains. China's industrial growth has attracted foreign direct investment that might otherwise have gone elsewhere; some industries in Northeast and Southeast Asia have been displaced by competition from China; but Asian suppliers also have been increasingly feeding China's export processing industries and domestic markets. Large trade surpluses with China in 2002–03 contributed to the growth of most regional economies.

Enhanced regional economic linkages have served China's political agenda. Through increasingly active and sophisticated bilateral and multilateral diplomacy, China is presenting itself as a country that is peacefully rising, offering win-win solutions for its economic partners in Asia. It has shown a greater willingness in recent years to participate actively in multilateral forums on both economic and

security issues—such as APEC, the ASEAN Regional Forum, and the Shanghai Cooperation Organization. Evidence indicates that this diplomatic strategy is making inroads for China, despite a wariness of China's growing military power, particularly on the part of Japan.

*While China has undertaken a diplomatic offensive in Asia to reassure its neighbors of its long-term peaceful intentions, buying time and space in the process to pursue its economic development and military strengthening, countries in the region appear to perceive the United States as losing focus on Asia as it prosecutes the war on terrorism. The Commission believes that the United States' influence and vital long-term interests in Asia are being challenged by China's robust regional economic engagement and diplomacy, and that greater attention must be paid to U.S. relations in the region.*

**Recommendation:** Congress should revitalize U.S. engagement with China's Asian neighbors by encouraging U.S. diplomatic efforts to identify and pursue initiatives to demonstrate the United States' firm commitment to facilitating the economic and security needs of the region. These initiatives should have a regional focus and complement bilateral efforts. The Asia-Pacific Economic Cooperation forum (APEC) offers a ready mechanism for pursuit of such initiatives.

### ***Growing Tensions Across the Strait and in Hong Kong***

China has not offered win-win political solutions to Taiwan and Hong Kong. China has been building missile forces and positioning its military to deter Taiwan from taking political steps Beijing considers unacceptable moves towards independence and to coerce Taiwan to end the island's continued separate status. Further, China is using its political clout to keep Taiwan out of regional and bilateral economic arrangements and to otherwise economically marginalize the island. Taiwan President Chen Shui-bian's recent reelection and Chen's plan for constitutional revision have heightened China's anxiety regarding Taiwan and heightened the near-term prospects for conflict. In Hong Kong, China's National People's Congress has undercut Hong Kong's autonomy and self-governance by its recent unilateral decisions to rule out near-term direct elections for Hong Kong's chief executive and Legislative Council. Moreover, Beijing has engaged in a systemic campaign in recent weeks to intimidate the democracy movement in Hong Kong by depicting its leaders as unpatriotic toward China, directing an unprecedented visit of eight Chinese warships to Hong Kong's harbor, and prohibiting legislative debate on electoral matters in Hong Kong's legislature.

*China's recent actions toward Taiwan and Hong Kong call into question its commitments to a peaceful approach toward Taiwan and to preserving Hong Kong's autonomy and self-government. These developments merit a fresh look at U.S. policies in these areas by the Congress and executive branch. In particular, recent developments across the Strait are putting increasing stress on the United States' one China policy, demonstrating the need for a new assessment of this policy that takes into consideration current realities.*

**Recommendation:** Congress should consult with the administration to assess jointly whether the PRC's recent interventions impacting Hong Kong's autonomy constitute grounds for invoking the terms of the U.S.-Hong Kong Policy Act with regard to Hong Kong's separate treatment. This includes U.S. bilateral relations with Hong Kong in areas such as air services, customs treatment, immigration quotas, visa issuance, and export controls. In this context, Congress should assess the implications of the National People's Congress Standing Committee's intrusive interventions with regard to matters of universal suffrage and direct elections. Congress and the administration should continue to keep Hong Kong issues on the U.S.-PRC bilateral agenda and work closely with the United Kingdom on Hong Kong issues.

**Recommendation:** Congress should enhance its oversight role in the implementation of the Taiwan Relations Act. Executive branch officials should be invited to consult on intentions and report on actions taken to implement the TRA through the regular committee hearing process of the Congress, thereby allowing for appropriate public debate on these important matters. In this same context, Congress and the administration should conduct a fresh assessment of the one China policy, given the changing realities in China and Taiwan. This should include a review of:

- The policy's successes, failures, and continued viability;
- Whether changes may be needed in the way the United States government coordinates its defense assistance to Taiwan, including the need for an enhanced operating relationship between U.S. and Taiwan defense officials and the establishment of a U.S.-Taiwan hotline for dealing with crisis situations.
- How U.S. policy can better support Taiwan's breaking out of the international economic isolation that the PRC seeks to impose on it and whether this issue should be higher on the agenda in U.S.-China relations. Economic and trade policy measures that could help ameliorate Taiwan's marginalization in the Asian regional economy should also be reviewed. These could include enhanced U.S.-Taiwan bilateral trade arrangements that would include protections for labor rights, the environment, and other important U.S. interests.

**Recommendation:** Congress should consult with the administration on developing appropriate ways for the United States to facilitate actively cross-Strait dialogue that could promote the long-term, peaceful resolution of differences between the two sides and could lead to direct trade and transport links and/or other cross-Strait confidence-building measures. The administration should be directed to report to Congress on the status of cross-Strait dialogue, the current obstacles to such dialogue, and, if appropriate, efforts that the United States could undertake to promote such a dialogue.

### ***China's Intermediary Role in the Standoff with North Korea***

China has become a major diplomatic player in the ongoing standoff with North Korea over Pyongyang's development of nuclear weapons. As host of the Six Party Talks, China has helped bring North Korea to the table; but has not adequately employed

its considerable political and economic leverage over North Korea to drive Pyongyang towards acceptance of the goal of achieving a complete, verifiable, and irreversible dismantlement of North Korea's nuclear weapons programs. Even as events in North Korea unfold, Chinese state companies continue to pursue deals to sell WMD-related items to countries of concern to the United States. The United States has repeatedly imposed sanctions in response to these activities; but sanctions remain limited to penalizing offending companies, despite many of these companies' direct affiliation with top levels of the PRC government or military.

*The United States has placed great faith in China's ability to move North Korea toward renouncing its nuclear weapons programs. The U.S.-China working relationship to defuse this crisis has been lauded as an essential component in bilateral relations, one that appears to trump other areas of U.S. concern. The Commission believes China has not effectively utilized its substantial leverage over North Korea to produce a workable resolution and regards China's performance in this regard over the next few months as a key test of the U.S.-China relationship.*

**Recommendation:** Should the current stalemate in the Six Party Talks continue, Congress should press the administration to work with its regional partners, intensify its diplomacy, and ascertain North Korean and Chinese intentions with a detailed and staged proposal beginning with a freeze of all North Korea's nuclear weapons programs, followed by a verifiable and irreversible dismantlement of those programs. Further work in this respect needs to be done to determine whether a true consensus on goals and process can be achieved with China. If this fails, the United States must confer with its regional partners to develop new options to resolve expeditiously the standoff with North Korea, particularly in light of public assessments that the likely Korean uranium enrichment program might reach a stage of producing weapons by 2007.

**Recommendation:** Congress should press the administration to renew efforts to secure China's agreement to curtail North Korea's commercial export of ballistic missiles and to encourage China to provide alternative economic incentives for the North Koreans to substitute for the foreign exchange that would be foregone as a result of that curtailment.

### ***China's Energy Trajectory and the Implications for Global Energy Markets***

China has moved past Japan to rank second behind the United States in global energy consumption, and is the world's second largest oil consumer and its third largest oil importer. These trends have made China increasingly dependent on imported energy sources. China has pursued its energy security strategy via bilateral energy deals, and does not maintain a meaningful strategic petroleum reserve or participate in multilateral energy market stabilizing arrangements. China's rising energy demand has put added pressure on global petroleum supplies and prices. Indeed, the recent escalation in gasoline prices in the United States has been attributed, in part, to the impact of China's growing pressure on



world oil supplies and the absence of any mechanism in place to counter this pressure and maintain stable prices for consumers. It also has had consequences for China's economy, as energy shortages and blackouts have led to slowdowns in industrial production in certain sectors.

Energy needs have driven China closer to the Middle East and Africa, as well as neighbors in Central Asia, Russia and the Pacific. China seeks to lock in secure energy supplies, especially new sources of gas and oil not subject to potential disruption in a time of conflict. China has sought energy cooperation with countries of concern to the United States, including Iran and Sudan, which are inaccessible by U.S. and other western firms. Some analysts have voiced suspicions that China may have offered WMD-related transfers as a component of some of its energy deals.

*China's growing energy needs, linked to its rapidly expanding economy, are creating economic and security concerns for the United States. China's energy security policies are driving it into bilateral arrangements that undermine multilateral efforts to stabilize oil supplies and prices, and in some cases may involve dangerous weapons transfers.*

**Recommendation:** Congress should direct the secretaries of State and Energy to consult with the International Energy Agency with the objective of upgrading the current loose experience-sharing arrangement, whereby China engages in some limited exchanges with the organization, to a more structured arrangement whereby the PRC would be obligated to develop a meaningful strategic reserve, and coordinate release of stocks in supply disruption crises or speculator-driven price spikes.

### **Technology and Military Advancements**

China has undergone rapid advancements in technology development, military modernization, and media control. These advancements are altering bilateral and regional trade flows, the cross-strait military balance, and the Chinese government's ability to control the media and shape perceptions of the United States and its policies.

### ***China's Coordinated National Strategy for Technology Development***

The Chinese government has developed and pursued a coordinated strategy for attracting and directing national and foreign investment into high-tech research, development, and production. This strategy for high-tech investment has been a sustained, multi-year effort that has paid dividends for economic growth, science and technology institutions, educational infrastructure, technical levels of workers and industries, and military modernization. The United States and other foreign partners—both commercial and governmental—have contributed significantly to these developments. U.S. advanced technology and technological expertise is transferred to China in a number of ways, both legal and illegal, including through U.S. invested firms and research centers in China, Chinese investments in the United States, bilateral science and technology (S&T) cooperative programs, and Chinese students

and researchers who return home following their work and study at U.S. universities and research institutes.

*China's development as a locus of high-technology manufacturing and R&D has been a key component of its economic reform strategy, and the pace of this development has exceeded many outside observers' expectations. What China does with its growing technology capabilities—whether it converts them to military uses and/or to control the free flow of information to its population—is of direct national security concern to the United States. Moreover, the extent to which these advances allow China to challenge U.S. competitiveness in technology development is a vital matter for U.S. economic security.*

The U.S. government collects inadequate data on the shifts of U.S. high-tech investment, technology transfers, and R&D to China. Information on U.S. transfers of technology subject to export licensing is compiled and government reporting on official S&T cooperation efforts has improved somewhat under Congressional mandate; but the overall picture of U.S. contributions to the development of China's technology growth and R&D base is not at all clear. Assessments of the implications of these shifts for the United States' long-term technological superiority and for China's competitiveness—both commercially and militarily—are difficult to make as a result of this gap in knowledge. Moreover, the process by which the U.S. government reviews acquisitions of American companies by Chinese and other foreign investors—the Committee on Foreign Investment in the United States (CFIUS)—focuses solely on traditional national security concerns with such investments, while failing to consider broader U.S. economic security interests.

***Recommendation:*** Congress should direct the administration to develop and publish a coordinated, comprehensive national policy and strategy designed to meet China's challenge to the maintenance of our scientific and technological leadership and competitiveness in the same way it is presently required to develop and publish a national security strategy.

***Recommendation:*** Congress should revise the law governing the CFIUS process to expand the definition of national security to include the potential impact on national economic security as a criterion to be reviewed, and should direct the administration to transfer chairmanship of CFIUS from the Secretary of the Treasury to the Secretary of Commerce.

### ***Military Modernization and the Shift in the Cross-Strait Military Balance***

Commission research and hearings indicate that China's military capabilities increasingly appear to be shaped to fit a Taiwan conflict scenario and to target U.S. air and naval forces that could become involved. China's modern arsenal includes an increasingly sophisticated nuclear missile force that is of direct strategic concern to the United States, while in the Western Pacific theater China has deployed over five hundred conventional short-range ballistic missiles that threaten Taiwan and longer-range conventional missiles that could threaten Japan and U.S. forces deployed in the region. China's advanced naval and air weapons systems—including

surface ships, submarines, anti-ship missiles, and advanced fighter aircraft—have been significantly enhanced by infusions of foreign military technology, co-production assistance and direct purchases, mainly from Russia and, to a lesser extent, from Israel.

*China's quantitative and qualitative military advancements have resulted in a dramatic shift in the cross-Strait military balance toward China, with serious implications for Taiwan, for the United States, and for cross-Strait relations.*

**Recommendation:** Congress should urge the President and the secretaries of State and Defense to press strongly their European Union counterparts to maintain the EU arms embargo on China.

**Recommendation:** Congress should direct the administration to restrict foreign defense contractors who sell sensitive military-use technology or weapons systems to China from participating in U.S. defense-related cooperative research, development, and production programs, which restriction can be targeted to cover only those technology areas involved in the transfer to China, and to provide a comprehensive annual report to the appropriate committees of Congress on the nature and scope of foreign military sales to China, particularly from Russia and Israel.

### ***Continued Controls Over The Media***

The Chinese government continues to exercise strong controls on the dissemination of information via the public media. While there has been some loosening of controls on reporting of news relating to many areas of business and society in China, red lines remain that are dangerous for individuals or organizations to exceed.

The Chinese government's propaganda machinery has not withered away during twenty-five years of reform and opening; rather it has modernized. This was proven beyond doubt during the SARS epidemic of 2003. The Chinese government's intensive efforts to cover up the outbreak of SARS showed the breadth of the government's control, while the ability of many in the population to nonetheless access information about the epidemic via the Internet, text messaging, and other new media demonstrated the limitations of this control in a growing high-tech society.

Government censorship; jamming of some overseas broadcasts, including those of U.S. government-sponsored outlets like the Voice of America; blocking of foreign and domestic Internet Web sites; and punishments for those who disseminate information beyond the government's tolerance remain widespread. Open criticism of China's leaders, questioning of the Communist Party and its policies, organizational activities that are independent of government control, and anything perceived as conducive to political conduct remains taboo in the public media. The Chinese government has used its control over the media to shape the population's perceptions of the United States and its policies, leading to a consistent message in the Chinese media that has been particularly critical of U.S. foreign policy and intentions in Asia.

*Despite the Chinese government's much heralded reversal of policy to encourage more open and accurate reporting of SARS during last year's outbreak, there has in practice been no fundamental change in the Chinese government's approach to controlling the*

*media, including information available through the Internet. This control shapes the Chinese population's perceptions of the United States and its policies, enhancing the risk of misperception and miscalculation in the bilateral relationship and increasing the potential for, and the difficulty of, managing crisis situations.*

**Recommendation:** Congress should enhance funding for the Broadcasting Board of Governors' programs aimed at circumventing China's Internet firewall through the development of anticensorship technologies and methods, and direct the Department of Commerce and other relevant agencies to conduct a review of export administration regulations to determine whether restrictions are needed on the export of U.S. equipment, software, and technologies that permit the Chinese government to surveil its own people or censor free speech.

### CONCLUSION

It is now commonplace to assert that the U.S.-China relationship will be our most significant bilateral relationship during the Twenty-First Century. Our trade and investment with China already has an enormous impact on the U.S. economy, and the security challenges before us are of the highest order. Through an appropriate mix of U.S. policies, this complex relationship can be managed in such a way as to minimize the downside risks, and enhance the prospects of moving China toward a more open, democratic and market-oriented society, to the benefit of both our economic and national security interests.

As we stated at the outset, we have concluded that a number of the current trends in U.S.-China relations are presently moving in the wrong direction. With a renewed and realistic focus on the relationship by the Congress, we are optimistic that U.S. policy toward China can be put on a more solid, productive footing to tackle the long-term challenges that lie ahead.

## **RECOMMENDATIONS TO CONGRESS**

### **CHAPTER 1—CHINA'S INDUSTRIAL, INVESTMENT, AND EXCHANGE RATE POLICIES**

#### **Recommendations for Dealing with China's Currency Manipulation**

- The 1988 Omnibus Trade and Competitiveness Act requires the Treasury Department to examine whether countries are manipulating their exchange rates for purposes of gaining international competitive advantage. The Treasury is to arrive at its finding in consultation with the IMF, which defines manipulation as “protracted large-scale intervention in one direction in the exchange market.” The Treasury has repeatedly evaded reporting on this test. The Commission recommends that Congress require the Treasury to explicitly address this test in its required report to Congress. Furthermore, a condition for taking action against a country that manipulates its currency is that an offending country be running a material global current account surplus in addition to a bilateral surplus. The Commission recommends that Congress amend this provision so that a material global current account surplus is not a required condition.
- The administration should use all appropriate and available tools at its disposal to address and correct the problem of currency manipulation by China and other East Asian countries. With regard to China, this means bringing about a substantial upward revaluation of the yuan against the dollar. Thereafter, the yuan should be pegged to a trade-weighted basket of currencies, and provisions should be established to guide future adjustments if needed. As part of this process, the Treasury Department should engage in meaningful bilateral negotiation with the Chinese government, and it should also engage in meaningful bilateral negotiations with Japan, Taiwan, and South Korea regarding ending their long-standing exchange rate manipulation. The administration should concurrently encourage our trading partners with similar interests to join in this effort. The Commission recommends that Congress pursue legislative measures that direct the administration to take action—through the WTO or otherwise—to combat China's exchange rate practices in the event that no concrete progress is forthcoming.

#### **Recommendations for Addressing China's Mercantilist Industrial and FDI Policies**

- The Commission recommends that Congress direct the United States Trade Representative (USTR) and the Department of Commerce to undertake immediately a comprehensive investigation of China's system of government subsidies for manufacturing, including tax incentives, preferential access to credit and

capital from state-owned financial institutions, subsidized utilities, and investment conditions requiring technology transfers. The investigation should also examine discriminatory consumption credits that shift demand toward Chinese goods, Chinese state-owned banks' practice of noncommercial-based policy lending to state-owned and other enterprises, and China's dual pricing system for coal and other energy sources. USTR and Commerce should provide the results of this investigation in a report to Congress that assesses whether any of these practices may be actionable subsidies under the WTO and lays out specific steps the U.S. government can take to address these practices.

- The Commission recommends that Congress direct the administration to undertake a comprehensive review and reformation of the government's trade enforcement infrastructure in light of the limited efforts that have been directed at enforcing our trade laws. Such a review should include consideration of a proposal by Senator Ernest Hollings (D-SC) to establish an assistant attorney general for international trade enforcement in the Department of Justice to enhance our capacity to enforce our trade laws. Moreover, the U.S. government needs to place an emphasis on enforcement of international labor standards and appropriate environmental standards.
- The Commission recommends that Congress direct the administration to work with other interested WTO members to convene an emergency session of the WTO governing body to extend the MFA at least through 2008 to provide additional time for impacted industries to adjust to surges in imports from China.

#### **CHAPTER 2—CHINA IN THE WORLD TRADE ORGANIZATION: COMPLIANCE, MONITORING, AND ENFORCEMENT**

- The Commission recommends that Congress press the administration to make more use of the WTO dispute settlement mechanism and/or U.S. trade laws to redress unfair Chinese trade practices. In particular, the administration should act promptly to address China's exchange rate manipulation, denial of trading and distribution rights, lack of IPR protection, objectionable labor standards, and subsidies to export industries. In pursuing these cases, Congress should encourage USTR to consult with trading partners who have mutual interests at the outset of each new trade dispute with China.
- The Commission recommends that Congress press the administration to make better use of the China-specific section 421 and textile safeguards negotiated as part of China's WTO accession agreement to give relief to U.S. industries especially hard hit by surges in imports from China.
- Notwithstanding China's commitments at the April 2004 JCCT meeting, the Commission recommends that Congress press the administration to file a WTO dispute on the matter of China's failure to protect intellectual property rights. China's WTO obligation to protect intellectual property rights demands not only that China promulgate appropriate legislation and regulations, including enacting credible criminal penalties, but also that these rules be enforced. China has repeatedly promised, over many years, to take significant action. Follow-through and action have

been limited and, therefore, the Commission believes that immediate U.S. action is warranted.

- The Commission recommends that Congress urge the Department of Commerce to make countervailing duty laws applicable to nonmarket economies. If Commerce does not do so, Congress should pass legislation to achieve the same effect. U.S. policy currently prevents application of countervailing duty laws to non-market economy countries such as China. This limits the ability of the United States to combat China's extensive use of subsidies that give Chinese companies an unfair competitive advantage.
- The Commission recommends that Congress encourage the administration to make a priority of obtaining and ensuring China's compliance with its WTO commitments to refrain from forced technology transfers that are used as a condition of doing business. The transfer of technology by U.S. investors in China as a direct or indirect government-imposed condition of doing business with Chinese partners remains an enduring U.S. security concern as well as a violation of China's WTO agreement. A WTO complaint should be filed when instances occur.
- The Commission recommends that Congress encourage USTR and other appropriate U.S. government officials to take action to ensure that the WTO's Transitional Review Mechanism process is a meaningful multilateral review that measures China's compliance with its WTO commitments. If China continues to frustrate the TRM process, the U.S. government should initiate a parallel process that includes a specific and comprehensive measurement system. The United States should work with the European Union, Japan, and other major trading partners to produce a separate, unified annual report that measures and reports on China's progress toward compliance and coordinates a plan of action to address shortcomings. This report should be provided to Congress. In addition, independent assessments of China's WTO compliance conducted by the U.S. government, such as USTR's annual report, should be used as inputs in the multilateral forum evaluating China's compliance, whether that forum is a reinvigorated and effective TRM or a new process.
- The Commission recommends that Congress consider options to assist small- and medium-sized business in pursuing trade remedies under U.S. law, such as through section 421 cases.

### **CHAPTER 3—CHINA'S PRESENCE IN THE GLOBAL CAPITAL MARKETS**

- The Commission recommends that Congress reinstate the reporting provision of the 2003 Intelligence Authorization Act [P.L. 107–306, Sec. 827] directing the director of central intelligence (DCI) to prepare an annual report identifying Chinese or other foreign companies determined to be engaged or involved in the proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in the U.S. capital markets. The Commission further recommends that Congress expand this provision to require the DCI to undertake a broader review of the security-related concerns of Chinese firms accessing, or seeking to access, the U.S. capital markets. This should include the establishment of a new interagency process of

consultations and coordination among the National Security Council, the Treasury Department, the State Department, the SEC, the Federal Bureau of Investigation (FBI), and the intelligence community regarding Chinese companies listing or seeking to list in the U.S. capital markets. The aim of such an inter-agency process should be to improve collection management and assign a higher priority to assessing any linkages between proliferation and other security-related concerns and Chinese companies, including their parents and subsidiaries, with a presence in the U.S. capital markets.

- The Commission recommends that Congress require mutual funds to more fully disclose the specific risks of investments in China. This should include disclosure to investors of the identities of any local firms subcontracted by funds to perform due diligence on Chinese firms held in their portfolios. Subcontractors' principal researchers, location, experience, and potential conflicts of interest should all be disclosed.
- The Commission recommends that Congress direct the Commerce Department and USTR to evaluate whether Chinese state-owned banks' practice of noncommercial-based policy lending to state-owned and other enterprises constitutes an actionable WTO-inconsistent government subsidy and include this evaluation in the report on subsidies recommended in Chapter 1.
- In its 2002 Report, the Commission recommended that Congress prohibit debt or equity offerings in U.S. capital markets by any Chinese or foreign entity upon which the State Department has imposed sanctions for engaging in the proliferation of weapons of mass destruction (WMD) or ballistic missile delivery systems. The Commission further believes that Congress should bar U.S. institutional or private investors from making debt or equity investments, directly or indirectly, in firms identified and sanctioned by the U.S. government for weapons proliferation-related activities, whether they are listed and traded in the United States or in the Chinese or other international capital markets. For example, NORINCO, a company sanctioned by the U.S. government, is currently available for purchase on the Chinese A share market. U.S.-based qualified foreign institutional investors that have rights to trade on this exchange should not be permitted to invest in NORINCO or any other firm officially determined to have engaged in the proliferation of WMD or ballistic missiles.

#### **CHAPTER 4—CHINA'S REGIONAL ECONOMIC AND SECURITY IMPACTS AND THE CHALLENGES OF HONG KONG AND TAIWAN**

##### **Regional Engagement**

- The Commission recommends that Congress revitalize U.S. engagement with China's Asian neighbors by encouraging U.S. diplomatic efforts to identify and pursue initiatives to demonstrate the United States' firm commitment to facilitating the economic and security needs of the region. These initiatives should have a regional focus and complement bilateral efforts. The Asia-Pacific Economic Cooperation forum (APEC) offers a ready mechanism for pursuit of such initiatives. The United States should consider



further avenues of cooperation by associating with regional forums of which it is not a member.

### **Hong Kong**

- The Commission recommends that Congress consult with the administration to assess jointly whether the PRC's recent interventions impacting Hong Kong's autonomy constitute grounds for invoking the terms of the U.S.-Hong Kong Policy Act with regard to Hong Kong's separate treatment. This includes U.S. bilateral relations with Hong Kong in areas such as air services, customs treatment, immigration quotas, visa issuance, and export controls. In this context, Congress should assess the implications of the National People's Congress Standing Committee's intrusive interventions with regard to matters of universal suffrage and direct elections. Congress and the administration should continue to keep Hong Kong issues on the U.S.-PRC bilateral agenda and work closely with the United Kingdom on Hong Kong issues.

### **Cross-Strait Issues**

- The Commission recommends that Congress enhance its oversight role in the implementation of the Taiwan Relations Act. Executive branch officials should be invited to consult on intentions and report on actions taken to implement the TRA through the regular committee hearing process of the Congress, thereby allowing for appropriate public debate on these important matters. This should include, at a minimum, an annual report on Taiwan's request for any military equipment and technology and a review of U.S.-Taiwan policy in light of the growing importance of this issue in U.S.-China relations.
- The Commission recommends that the Congress and the administration conduct a fresh assessment of the one China policy, given the changing realities in China and Taiwan. This should include a review of:
  - The policy's successes, failures, and continued viability;
  - Whether changes may be needed in the way the U.S. government coordinates its defense assistance to Taiwan, including the need for an enhanced operating relationship between U.S. and Taiwan defense officials and the establishment of a U.S.-Taiwan hotline for dealing with crisis situations;
  - How U.S. policy can better support Taiwan's breaking out of the international economic isolation that the PRC seeks to impose on it and whether this issue should be higher on the agenda in U.S.-China relations. Economic and trade policy measures that could help ameliorate Taiwan's marginalization in the Asian regional economy should also be reviewed. These should include enhanced U.S.-Taiwan bilateral trade arrangements that would include protections for labor rights, the environment, and other important U.S. interests.
- To support this policy review, the Commission recommends that the appropriate committees of Congress request that the executive branch make available to them a comprehensive catalogue and copies of all the principal formal understandings and other communications between the United States and both China and

Taiwan as well as other key historical documents clarifying U.S. policy toward Taiwan.

- The Commission recommends that Congress consult with the administration on developing appropriate ways for the United States to facilitate actively cross-Strait dialogue that could promote the long-term, peaceful resolution of differences between the two sides and could lead to direct trade and transport links and/or other cross-Strait confidence-building measures. The administration should be directed to report to Congress on the status of cross-Strait dialogue, the current obstacles to such dialogue, and, if appropriate, efforts that the United States could undertake to promote such a dialogue.

#### **CHAPTER 5—CHINA'S PROLIFERATION PRACTICES AND THE CHALLENGE OF NORTH KOREA**

- Should the current stalemate in the Six Party Talks continue, the Commission recommends that Congress press the administration to work with its regional partners, intensify its diplomacy, and ascertain North Korean and Chinese intentions with a detailed and staged proposal beginning with a freeze of all North Korea's nuclear weapons programs, followed by a verifiable and irreversible dismantlement of those programs. Further work in this respect needs to be done to determine whether a true consensus on goals and process can be achieved with China. If this fails, the United States must confer with its regional partners to develop new options to resolve expeditiously the standoff with North Korea, particularly in light of public assessments that the likely North Korean uranium enrichment program might reach a stage of producing weapons by 2007.
- The Commission recommends that Congress press the administration to renew efforts to secure China's agreement to curtail North Korea's commercial export of ballistic missiles and to encourage China to provide alternative economic incentives for the North Koreans to substitute for the foreign exchange that would be forgone as a result of that curtailment.
- As recommended in the Commission's 2002 Report, and now similarly proposed by President Bush and the U.N. Secretary General, the Commission reiterates that Congress should support U.S. efforts to work with the U.N. Security Council to create a new U.N. framework for monitoring the proliferation of weapons of mass destruction and their delivery systems in conformance with member nations' obligations under the Nuclear Non-Proliferation Treaty, the Biological Weapons Convention, and the Chemical Weapons Convention. This new monitoring body would be delegated authority to apply sanctions to countries violating these treaties in a timely manner or, alternatively, would be required to report all violations in a timely manner to the Security Council for discussion and sanctions.<sup>1</sup>
- As recommended in the Commission's 2002 Report, the Commission reiterates that Congress should act to broaden and harmonize proliferation sanctions by amending all current statutes that pertain to proliferation to include a new section authorizing the president to invoke economic sanctions against foreign nations that proliferate WMD and technologies associated with

WMD and their delivery systems. These economic sanctions would include import and export limitations, restrictions on access to U.S. capital markets, restrictions on foreign direct investment into an offending country, restrictions on transfers by the U.S. government of economic resources, and restrictions on science and technology cooperation or transfers. The new authority should require the president to report to Congress the rationale and proposed duration of the sanctions within seventy-two hours of imposing them. Although the president now has the authority to select from the full range of economic and security-related sanctions, these sanctions are case specific and relate to designated activities within a narrow set of options available on a case-by-case basis.<sup>2</sup>

#### **CHAPTER 6—CHINA'S ENERGY NEEDS AND STRATEGIES**

- The Commission recommends that Congress direct the secretaries of State and Energy to consult with the International Energy Agency with the objective of upgrading the current loose experience-sharing arrangement, whereby China engages in some limited exchanges with the organization, to a more structured arrangement whereby the PRC would be obligated to develop a meaningful strategic reserve, and coordinate release of stocks in supply disruption crises or speculator-driven price spikes.<sup>3</sup>
- The Commission recommends that Congress encourage work that increases bilateral cooperation in improving China's energy efficiency and environmental performance, such as further cooperation in Clean Coal Technology and waste-to-liquid-fuels programs, subject to any overriding concerns regarding technology transfers. Further, the Commission recommends that Congress direct the State and Energy departments, and the intelligence community, to conduct an annual review of China's international energy relationships and its energy practices during times of global energy crises to determine whether such U.S. assistance continues to be justified.
- The Commission recommends that the Commerce Department and USTR investigate whether China's dual pricing system for coal and any other energy sources constitutes a prohibited subsidy under the WTO and include this assessment in the Commerce/USTR report on subsidies recommended in Chapter 1.

#### **CHAPTER 7—CHINA'S HIGH-TECHNOLOGY DEVELOPMENT AND U.S.-CHINA SCIENCE AND TECHNOLOGY COOPERATION**

- The U.S. government must develop a coordinated, comprehensive national policy and strategy designed to meet China's challenge to the maintenance of our scientific and technological leadership. America's economic competitiveness, standard of living, and national security are dependent on such leadership. The Commission therefore recommends that Congress charge the administration to develop and publish such a strategy in the same way it is presently required to develop and publish a national security strategy that deals with our military and political challenges around the world. In developing this strategy, the administration should utilize data presently compiled by the Department of

Commerce to track our nation's technological competitiveness in comparison with other countries.

- The Commission recommends that Congress revise the law governing the CFIUS process (Title VII of the Defense Production Act)—which gives the president authority to investigate mergers, acquisitions, or takeovers of U.S. firms by foreign persons if such activities pose a threat to national security—to expand the definition of national security to include the potential impact on national economic security as a criterion to be reviewed. In this regard, the term national economic security should be defined broadly without limitation to particular industries.
- The Commission recommends that Congress direct the administration to transfer chairmanship of CFIUS from the Secretary of the Treasury to the Secretary of Commerce.

#### **CHAPTER 8—CHINA'S MILITARY MODERNIZATION AND THE CROSS-STRAIT BALANCE**

- The annual report to Congress recommended in Chapter 4 on Taiwan's requests for military equipment and technology should include an assessment of the new military systems required by Taiwan to defend against advanced PRC offensive capabilities.
- As recommended in Chapter 4, Congress and the administration should review the need for a direct communications hotline between the United States and Taiwan for dealing with crisis situations. This is important in light of the short time frame of potential military scenarios in the Strait, together with Chinese strategic doctrine emphasizing surprise and deception.
- The Commission recommends that Congress urge the president and the secretaries of State and Defense to press strongly their European Union counterparts to maintain the EU arms embargo on China.
- The Commission recommends that Congress direct the administration to restrict foreign defense contractors who sell sensitive military-use technology or weapons systems to China from participating in U.S. defense-related cooperative research, development, and production programs. This restriction can be targeted to cover only those technology areas involved in the transfer to China.
- The Commission recommends that Congress request the Department of Defense to provide a comprehensive annual report to the appropriate committees of Congress on the nature and scope of foreign military sales to China, particularly from Russia and Israel.

#### **CHAPTER 9—MEDIA AND INFORMATION CONTROL IN CHINA**

- On June 30, 2003, the Commission recommended that Congress direct the Broadcasting Board of Governors to target funds for efforts aimed at circumventing China's Internet firewall through the development of anticensorship technologies and methods. Congress approved such funding as part of the 2004 Omnibus Appropriations Act. The Commission recommends that Congress continue this program with enhanced resources, pending successful results for the current fiscal year.

- As recommended in the Commission's 2002 Report, the Commission reiterates that Congress should direct the Department of Commerce and other relevant agencies to conduct a review of export administration regulations to determine whether specific measures should be put in place to restrict the export of U.S. equipment, software, and technologies that permit the Chinese government to surveil its own people or censor free speech.
- The Commission recommends that Congress approve legislation to establish an Office of Global Internet Freedom within the executive branch, tasked with implementing a comprehensive global strategy to combat state-sponsored blocking of the Internet and persecution of users. The strategy should include the development of anticensorship technologies.
- The Commission recommends that Congress encourage the administration to press China to freely admit U.S. government-sponsored journalists, such as those representing the Voice of America and Radio Free Asia. China frequently denies visas for such journalists, despite the fact that China's state-sponsored journalists are freely admitted in the United States. Options should be considered for linking Chinese cooperation to concrete consequences, including the possible use of U.S. visas for Chinese government journalists as leverage to gain admission of more U.S. government-supported journalists to China.

#### ENDNOTES

1. Recognizing deficiencies and loopholes in the current nuclear nonproliferation regime, President Bush has made several new proposals. First, that the Nuclear Suppliers Group nations (forty members) "refuse to sell enrichment and reprocessing equipment and technologies to any state that does not already possess full-scale, functioning enrichment and reprocessing plants." Second, an "Additional Protocol" has been submitted to the Senate for ratification. This protocol requires members of the NSG to declare a wide range of nuclear activities and facilities and for these to be open to IAEA inspectors. Only those countries that agree to the protocol would be allowed to import equipment for civilian nuclear programs. And third, the president proposed a new IAEA committee to focus on safeguards and verification and that IAEA members would be precluded from serving on the board of governors or the special committee if they are under investigation for violations of the NPT.

2. Under the International Economic Emergency Powers Act (IEEPA), the president does have the authority to select from the range of sanctions, but this implementation is an unlikely remedy as the IEEPA is to be invoked only in the event of a national economic emergency.

3. The IEA is an autonomous body within the OECD. OECD membership is limited to countries that can demonstrate its attachment to the basic values shared by all OECD members: an open market economy, democratic pluralism, and respect for human rights.

## INTRODUCTION

The Commission's 2003–2004 reporting cycle was marked by a number of highly significant events that have underscored the expansive and complex nature of the U.S.-China bilateral relationship. These developments demonstrate the vital need for the U.S. government to devote the necessary resources to, and configure effective policies for, managing its relations with the People's Republic of China (PRC). While much of the nation's—and much of the world's—international focus has been on Iraq, Afghanistan, and the U.S. war on terrorism, the United States' relationship with China continues to evolve into our most significant bilateral relationship, one that poses both near-term and long-term economic and security challenges. Accordingly, U.S. policymakers must pay enhanced attention to the many facets of this important relationship.

Among the key developments affecting U.S.-China relations over the past year have been the following:

- Continuing growth of U.S.-China trade, which reached \$181 billion in goods trade in 2003, making China the United States' third largest trading partner, and continued growth of the U.S. goods trade deficit with China to \$124 billion, the United States' largest current and historic bilateral trade deficit.
- Continuing shifts in U.S. manufacturing to China and extensive domestic job losses in the U.S. manufacturing sector.
- The ongoing transition of power in China to a new generation led by President Hu Jintao and Premier Wen Jiabao.
- The escalating nuclear crisis on the Korean peninsula and China's role as intermediary.
- Heightening tensions in cross-Strait relations, marked by China's continued missile buildup and military modernization programs aimed at Taiwan, Taiwan's decision to hold a national referendum on the Chinese missile threat, and the reelection of Taiwan President Chen Shui-bian.
- Beijing's decision to undercut Hong Kong's autonomy and self-governance by unilaterally ruling out near-term direct elections for Hong Kong's chief executive and Legislative Council and prohibiting legislative debate in Hong Kong on this matter.

During the course of this reporting cycle, the Commission undertook a comprehensive analysis of the U.S.-China relationship in the nine areas specified in our Congressional mandate, examining them in the context of these and other emerging developments. The Commission held eleven public hearings, including field hearings in Columbia, South Carolina, and San Diego, California. Through these hearings, the Commission heard the perspectives of members of Congress, current and former senior U.S. government officials, representatives of industry and labor, academics and researchers, journalists, and individuals from trade-impacted communities. All

told, the Commission took testimony from more than one hundred thirty witnesses, the full record of which has been published in hearing-by-hearing volumes forwarded to the Congressional leadership and available on our Web site ([www.uscc.gov](http://www.uscc.gov)). A complete list of the hearings and witnesses can be found in appendix IV.

The field hearings and the publication of individual hearing volumes were new initiatives by the Commission this reporting cycle. The field hearings in South Carolina and San Diego allowed the Commission to hear “on-the-ground” perspectives in two regions of the country particularly affected by U.S.-China economic relations. The publication and distribution of our hearing records on a hearing-by-hearing basis, accompanied by a cover letter from the Commission setting out initial findings and, if appropriate, recommendations to Congress on the topic of the hearing, allowed more timely dissemination of the information elicited at our hearings to the Congress and to the interested public.

The Commission’s fact-finding and examination process also included supporting several significant research projects by outside experts. The Commission funded statistical analyses of China’s role in world trade and investment and China’s impact on the U.S. manufacturing base, and comprehensive reports on China’s acquisitions of foreign weapons and military technologies, as well as on China’s compliance record with its World Trade Organization (WTO) commitments. Moreover, the Commission continued its work in translating articles from influential publications within China discussing Beijing’s economic and security strategies and its perceptions of the United States. All of these items are available to the public on our Web site.<sup>1</sup>

To further support its research and investigations, the Commission undertook two fact-finding missions abroad. A delegation of the Commission traveled to the headquarters of the WTO offices in Geneva, Switzerland, during December 7–9, 2003, to interview WTO officials, officials of the U.S. Mission to the WTO, and representatives of key WTO member country delegations about China’s first two years of membership in the organization. A second Commission delegation traveled to Tokyo, Hong Kong, and Taipei during March 14–23, 2004, to meet with senior government officials, American and local business organizations, and experts from academia and the media on the economic and security implications for the region of China’s growing economic and political prowess. During the trip to Asia, the Commission delegation also observed the Taiwan presidential election on March 20, 2004.

### **STRUCTURE OF THE REPORT**

The Report presents its key findings, analysis, and recommendations to Congress in nine chapters, organized in three sections capturing the major themes of our Congressional mandate. While our analysis has been divided in this manner, all of these areas interrelate in assessing the broader question of how the U.S.-China economic relationship affects U.S. economic and national security interests. We recognize that the United States’ vast trade and investment relationship with China can never be divorced from the larger geopolitical and military developments at issue.

## **Section I: U.S.-China Trade and Economic Transfers**

- **Chapter 1—China’s Industrial, Investment, and Exchange Rate Policies**
- **Chapter 2—China in the World Trade Organization: Compliance, Monitoring, and Enforcement**
- **Chapter 3—China’s Presence in the Global Capital Markets**

The first section of the Report focuses on the economic dimension of the U.S.-China relationship. Bilateral trade and investment flows between the two countries are taking place on a massive and rapidly increasing scale. Assessing how these flows are affecting the U.S. economy—and with that U.S. economic security—is an essential area of the Commission’s work. In this section, the Commission examines three significant components of U.S.-China trade and investment: (1) China’s industrial, investment, and exchange rate policies and their impact in particular on the U.S. manufacturing base; (2) China’s record of compliance to date with its WTO commitments; and (3) U.S. financial flows to China via the global capital markets.

## **Section II: Regional and Geostrategic Developments**

- **Chapter 4—China’s Regional Economic and Security Impacts and the Challenges of Hong Kong and Taiwan**
- **Chapter 5—China’s Proliferation Practices and the Challenge of North Korea**
- **Chapter 6—China Energy Needs and Strategies**

This section groups chapters addressing China’s rise as a regional power and its central role in the global security challenges stemming from the proliferation of weapons of mass destruction (WMD) and access to energy supplies. Together, the chapters weigh the extent to which China is contributing to or undermining a more stable global security environment. China’s enhanced diplomatic efforts with its regional neighbors contrasts with its hard-line actions relating to democratic developments in Hong Kong and Taiwan. Its intermediary role in the North Korea nuclear crisis will be a major test of U.S.-China relations. Each of these developments poses serious challenges to existing U.S. interests and policies.

## **Section III: Technology and Military Advancements**

- **Chapter 7—China’s High-Technology Development and U.S.-China Science and Technology Cooperation**
- **Chapter 8—China’s Military Modernization and the Cross-Strait Balance**
- **Chapter 9—Media and Information Control in China**

This final section of the Report assesses China’s rapid advancements in technology development, military modernization, and media control. These advancements are altering bilateral and regional trade flows, the cross-Strait military balance, and the Chinese government’s ability to control the media and shape perceptions of the United States and its policies.



### FUTURE WORK

As the Commission moves into its third reporting cycle, it will continue its investigation into the areas outlined above and its year-to-year assessment of how the landscape is changing from the standpoint of U.S. economic and national security interests. Within this broad mandate, there are a number of areas that the Commission believes deserve particular attention over the coming year via Commission hearings and research. These areas include, but are not limited to, the following:

***Impact on the U.S. Economy***—The regional, state, and sectoral dislocations in the U.S. economy resulting from the bilateral trade and investment relationship and measures to help mitigate the impact of these dislocations on affected U.S. workers and communities.

***Global Factor Mobility***—The implications of increased mobility of capital, labor, and technology for the conduct and governance of international trade and economic activity.

***Tax Incentives***—How U.S. tax policies impact U.S. investment flows to China, particularly manufacturing and research and development (R&D).

***Capital Markets***—The role that state-invested enterprises (SIEs) play in the Chinese economy and as part of its capital markets strategies.

***Cross-Strait Policies***—The underlying premises of U.S. cross-Strait policies; how they have been altered by continuing changes on both sides of the Strait; and the policy adjustments the United States should make in response.

***Cooperation on Anti-Terrorism Initiatives***—The nature and extent of U.S.-China cooperation and coordination on anti-terrorism matters.

***U.S.-China Energy Relations***—How U.S. energy policies toward China impact other areas of concern in U.S.-China economic relations—such as manufacturing competitiveness—and how to find the appropriate balance.

***China's High-Technology Development***—The wide-ranging means by which U.S. technology flows to China and the effectiveness of U.S. government efforts to coordinate, monitor, evaluate, and address these flows; China's use of technology standards as a barrier to trade and an inducement for technology transfer; the policies and strategies implemented by the Chinese government to attract high-tech investment, including R&D, from the United States and other developed countries; and how these issues affect the competitiveness of the U.S. technology industry.

***Media Control***—Further review of the Chinese government's use of media controls to shape perceptions of the United States, in particular the effectiveness of e-mail, Internet access, and cell phone text messaging as forms of information flow in China; and the ability of the Chinese government to control these new media.

**ENDNOTE**

1. The research papers prepared by outside experts under contract to the Commission are intended to support the Commission's ongoing research efforts and are posted to the Commission's Web site in unedited form. The Commission's posting of these materials does not imply an endorsement by the Commission or any individual Commissioner of the views expressed therein.